

# Caledonia Mining

Expansion on track, a gold mine with purpose

Q4 & FY17 results

Metals & mining

FY17 saw Caledonia Mining (CMCL) marginally beat its 54-56koz gold production guidance, drive down AISC costs, its head grade increase (which had a corresponding positive effect on gold recoveries) and add significantly to its code-compliant resource base. In relation to its investment plan to lift production to 80koz by 2021, we see capex peaking this financial year (FY18), which will then allow significantly improved free cash flow generation. Coupled with an improved political environment and regulatory changes seemingly favouring gold miners (with a key objective of improving Zimbabwe's domestic US\$ currency supply), Caledonia is very well placed to capitalise on the long-overdue opening up of one of Africa's prime geological and mining gems.

Year end	Revenue (US\$m)	PBT* (US\$m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/16	62.0	19.6	106.9	28.4	8.9	3.0
12/17	69.8	22.4	79.0	31.4	12.1	3.3
12/18e	74.7	24.9	170.4	27.6	5.6	2.9
12/19e	80.8	33.9	223.1	0.0	4.3	N/A

Note: \*PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

## Production and costs beating guidance

Caledonia produced 56,133oz Au in FY17, a y-o-y increase of 11.4%, at all-in sustaining costs (AISC) of US\$847/oz, a y-o-y decrease of 7.1%. This resulted from an improving gold grade (a recent concern of investors, and one which should now be readdressed to the upside as the mine delves deeper into higher-grade resources) and higher tonnes processed from improving milling efficiency.

## Blanket rights issue

With the Zimbabwean government relaxing indigenisation requirements for gold miners, the Blanket gold mine is to undertake a US\$4m rights issue underwritten by CMCL's Zimbabwean subsidiary. Since this time we have seen CMCL announce that Blanket will receive an increased Export Credit Incentive (10% cf 3.5% previously). As a result we consider the rights issue may not be required. However, if this rights issue takes place it would likely leave CMCL again owning a controlling c 51% share of the Blanket mine.

## Valuation: Peak capex forces DCF higher

Our model has been adjusted for Q417 and FY17 results. All other forward-looking assumptions remain unchanged from our previous [note](#). Caledonia's net cash position at end FY17 was US\$11.3m (note: end-year payables grew to US\$12.7m largely due to a deferred ZESA payment), and we see this level increasing to US\$14.9m in 2018 (net of dividend payments totalling US\$2.9m) before we see a material shift in FCF generation in 2019, when we forecast net cash increasing 45% to US\$21.6m. With capex peaking in FY18, our DCF valuation reflects this strong FCF generation resulting from a successful investment plan (IP) build-out. This drives our DCF up 4.8% from 869p (FY17) to 911p on an FY18 basis.

1 May 2018

**Price** 687.50p

**Market cap** £73m

US\$/£:1.39

Net cash (US\$m) at 31 December 2017 11.3

Shares in issue 10.6m

Free float 95%

Code CMCL

Primary exchange AIM (CMCL), TSX (CAL)

Secondary exchange NYSE American (CMCL)

## Share price performance



% 1m 3m 12m

Abs 27.9 26.7 32.9

Rel (local) 19.9 29.4 28.1

52-week high/low 687.5p 415.0p

## Business description

Caledonia Mining mines gold at, and maintains management control over, its main operating asset, the 49%-owned Blanket gold mine in southern Zimbabwe. It is also progressing its understanding of a number of promising satellite projects close to Blanket.

## Next events

Q1 results May 2018

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## FY17 keeps IP on track, FY18e production c 57koz Au

A comparison of Caledonia's Q4 results with our estimates is given in Exhibit 1 below. Revenue and royalty payments rose in line with improving gold production during the quarter (see Exhibit 3 for tonnes milled, gold grade, recovery and gold production data), with revenues received and royalties paid exceeding our estimates by 10% and 18% respectively. Note that CMCL's revenue line includes refining costs and a revised 10% export incentive credit reimbursement (tax deductible, for 2018 only, reverting to our long-term 3.5% assumption for each year thereafter) paid by the Zimbabwean government, which could be viewed as a means of stimulating gold production in-country. On 4 April, Caledonia announced that it had been granted the ECI uplift to 10% by the Zimbabwean government. We do not yet consider this marked increase in the ECI as sustainable in the long term and so only assume it lasts for 2018, and will adjust future years ECI on a rolling basis. It could be viewed as a short-term measure to try and force artisanal gold miners in-country to formalise their operations and sell gold through the Zimbabwean reserve bank, rather than receiving informal/unregulated, paper-based monetary payments from these small artisanal gold mines. We see the export incentive credit scheme as growing in importance as the Zimbabwean government seeks to regain entry to global capital markets, potentially re-instate the Zimbabwean dollar (surely a prerequisite to obtaining debt on international markets) and as a means of alleviating the crippling effects of a domestic shortage of US dollars, to which its currency is pegged.

Operating costs came in a fraction lower than our forecasts, resulting in a 6% increase in gross profit over our Q417 forecast, alongside the improvement in revenue during the quarter. Although mine-site operating costs were stable quarter-on-quarter, the effects of a strengthening South African rand during Q417 on Caledonia's wage payments resulted in an increase in G&A to US\$1.4m, 16% above our forecast of US\$1.2m. However, FY17 G&A came in at US\$5.9m, a y-o-y reduction of 18.2%, resulting from lower advisory and consultancy fees. Caledonia attempted an acquisition which fell through and resulted in elevated advisory and consultancy costs of US\$7.9m in FY16.

**Exhibit 1: Q417 quarter-on-quarter comparison with Edison estimates**

	Q417e	Q417	% Change
Revenue (including refining costs and rebate)	17,830	19,599	10%
Royalty	(834)	(986)	18%
Operating costs	(9,263)	(9,188)	-1%
Depreciation	(953)	(1,014)	6%
Gross profit	6,779	8,411	24%
G&A	(1,183)	(1,370)	16%
Share based payments	-	(369)	-
Foreign exchange gain/(loss)	-	(396)	-
Other income	-	535	-
Operating profit	5,596	6,811	22%
Net interest	135	(7)	N/A
PBT (FRS 3)	5,731	6,804	19%
Tax (excludes deferred tax charge)	(14)	(2,815)	N/M
Deferred tax	(1,683)	-	N/M
PAT (FRS 3)	4,034	3,989	-1%
Minority interest	(891)	(757)	-15%
Attributable profit	3,143	3,232	3%
EPS (IFRS)	29.7	29.5	-1%

Source: Caledonia Mining, Edison Investment Research

## Production schedule changes – 11koz reduction in 2019

As reported in Caledonia's 10 November 2017 announcement titled 'Extension of Central Shaft Project', the company has had to make a significant near term adjustment to its gold production estimates. The main change is an 11koz reduction in estimated gold production for FY19, with 61koz now estimated, as opposed to previous guidance of 72koz. A further 10koz in 2020 gold production has also been made by Caledonia (see Exhibit 2 below). These meaningful shortfalls are due to ongoing constraints at the No. 4 Shaft, which handles the vast majority of material handling and transport of ore and waste to surface. We have previously commented (please refer to our September 2017 [update note](#)) that the underground tramming loop's completion served to alleviate material handling bottlenecks underground. However, Caledonia in the aforementioned 10 November 2017 announcement states that its tramming loop, along with the deepening of the Central Shaft to allow for an extended Blanket mine life to greater depths, forced it to pare back short-term production targets. The following table details the changes in Caledonia's short-term production compared to our previous production schedule and how gold production of 80koz (we estimate 80,688ozs Au) is still maintained for 2021:

<b>Exhibit 2: CMCL gold production revisions over Blanket ramp-up period to 80koz by 2021</b>					
	2018e	2019e	2020e	2021e	2022e
Tonnes milled (000's)	564	570	640	720	673
Revised Gold Production (koz Au)	59	61	68	80	80
Old gold production (koz Au)	64	72	78	81	80
% change	-7.5%	-15.5%	-12.5%	-0.6%	0.0%
New Edison EPS	170	223	345	446	364
Old Edison EPS	148	314	452	462	412
% change	14.8%	-28.9%	-23.8%	-3.5%	-11.6%

Source: Edison Investment Research and Caledonia Mining

Exhibit 2 above provides detail over the adjustment we have made to our model and the amount of gold produced per annum by the Blanket gold mine. Note that FY18 (2018) EPS is up 14.8% compared to our Q317 results note published January 2018, whilst production has decreased 7.5%. This is explained through the increased export incentive credit scheme, from 3.5% (in our January 2018 note) to 10% as announced by Caledonia 4 April 2018. We only apply the 10% ECI rate to our FY18 forecasts, with it kept constant at 3.5% thereafter. Whilst gold production remains unchanged from 2021, underlying tonnes have increased by c 11% per annum which we consider implies a commensurate c 8% reduction in forecast gold grade long-term (ie 2021 to 2026) from 4.0g/t Au to 3.7g/t Au.

## Deeper inferred resources left out of valuation for now

Previously (in our Q317 results note, published January 2018) we maintained production as per Caledonia's investment plan ending 2026. The company's recent decision to extend the Central Shaft accommodates a further five years of production, according to Caledonia, with production as per the revised production schedule given in the 10 November 2017 announcement ending 2031 (as opposed to 2026 previously). However, with our aforementioned grade and tonnage adjustments through to 2026, and noting that the entirety of the additional gold production from 2027 to 2031 being sourced from inferred mineral resources, we consider it prudent to omit this production (from 2027 to 2031) until further geological confidence over the grade and quantum of these inferred resources is established. Our valuation horizon is therefore maintained until 2026, with upside clearly linked to the inferred resources being upgrade in confidence. We expect Caledonia to be able to furnish the market with this information post-Central shaft completion and achieving 80koz gold production by 2021, which should then free up drilling locations along the 22 Level.

## Taxation: Changes reflect revised treatment of management fee

Caledonia's FY17 overall effective taxation charge reflects its ongoing high level of capital expenditure and a revised treatment by the Zimbabwean tax authority of CMCL's management fee.

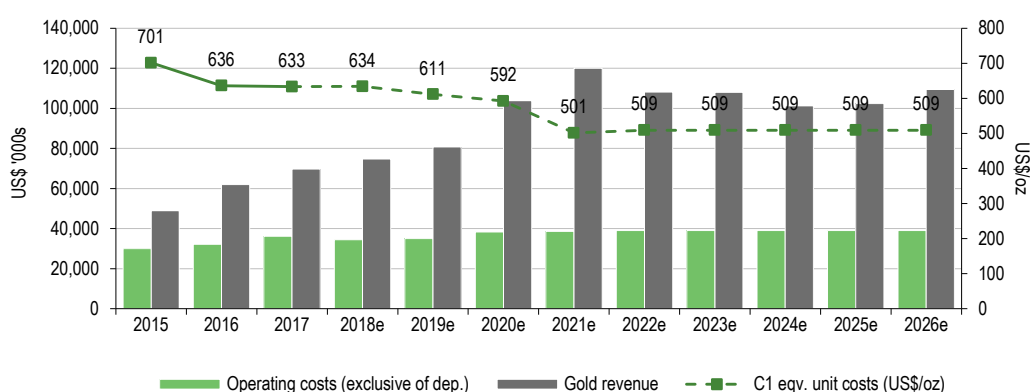
Caledonia's overall effective tax rate in FY17 was 42.2% (FY16: 41.0%), and its income tax rate was 18.3% (vs the headline rate of 25.75%), reflecting the deductibility of its high capital expenditure associated with the implementation of its investment plan. We note that withholding tax increased by a significant 142%, from US\$503k to US\$1,222k. Caledonia states that this was due to a change in the tax treatment of its management fee. Previously, Caledonia's management fee, paid from the Blanket mine to Caledonia Mining South Africa (CSMA) was taxed as income, however, we now understand that it is taxed as a dividend, thereby incrementally increasing withholding tax.

Note that the export credit incentive scheme is 100% tax deductible, and our tax calculations do not include any ECI payments to the Blanket gold mine.

## Costs coming down in tandem with production rising

A core reason for investment in Blanket is to fully realise the high level of operational gearing available due to the high level of fixed costs. As fixed costs remain flat, the more gold ounces a company produces, the lower its unit costs become. This is most clearly evidenced through the on-mine unit costs, as detailed in the following exhibit:

**Exhibit 3: Actual and forecast on-mine costs 2015-26e**

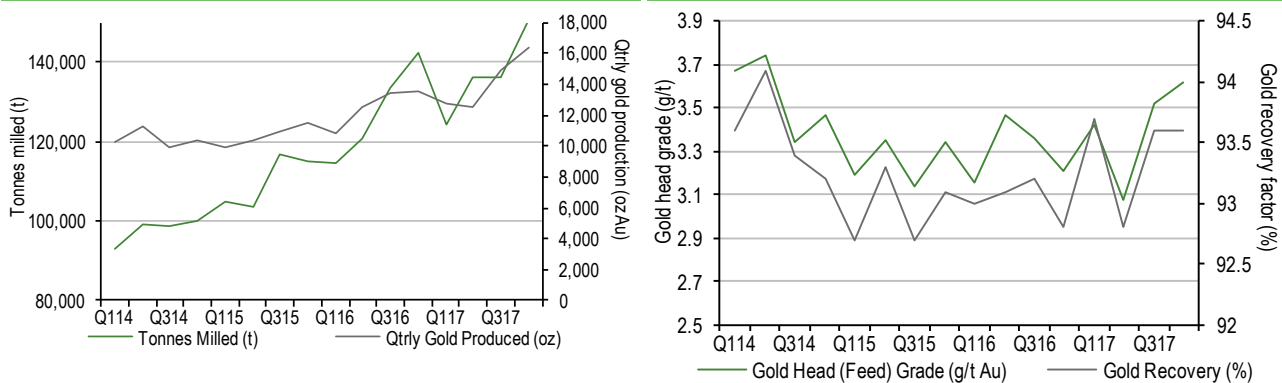


Source: Caledonia Mining, Edison Investment Research

With gold production forecast at around 57koz for 2018 (under our assumptions), unit costs should remain relatively flat moving only slightly from US\$633/oz for FY17, to US\$634/oz for FY18. However we do note that there is an indication Caledonia is operating at levels below this with on-mine costs per ounce reported for Q417 at US\$556/oz.

## Production: Following an upward path towards 2021

The Blanket gold mine demonstrated improved performance resulting from additional measures put in place over the year to help alleviate haulage bottlenecks and improve waste haulage capacity. Tonnes milled increased 6.0% y-o-y from 142,169t to 150,755t, and 10% q-o-q, from 136,064t to 150,755t. This pattern of improved operational performance (clearly visible in the trend of increasing tonnes milled and quarterly gold production, LHS in Exhibit 4 below) continues in line with Caledonia's ramp-up in production at Blanket to 80koz in 2021.

**Exhibit 4: Quarterly production data since launch of Blanket IP**


Source: Caledonia Mining and Edison Investment Research

## Central Shaft development and mid-shaft loading

The Central Shaft is the name given to the capital project most critical to a successful implementation of the IP launched in 2014, and which has been subsequently revised. Originally planned to a depth of 1,080m below surface, the current depth of the shaft is 990m below surface, corresponding to 30 level in Blanket's mine layout. The Central Shaft has been designed to become the main access and egress route for personnel at Blanket, and the main haulage route to transport ore and waste to surface. Its completion will alleviate a considerable burden on the existing and smaller capacity No 4 Shaft, allowing for considerable future growth potential to be realised below the 750m level. The 750m depth has been the historic 'floor' or depth limit to pushing Blanket's production downwards into what is currently understood to be higher-grade gold deposits.

Central Shaft development will now be completed to a depth of 1,330m below surface to provide additional scope for these extracting deeper and potentially higher-grade resources. The additional cost of this extension is already included in our financial model.

A further revision to the original Central Shaft development is the construction of a 'mid-shaft loading' system. This additional construction project was commenced during December 2017 at the 26 level, 870m below surface. It will serve to alleviate ore handling constraints on the 22 level haulage, and free up haulage capacity at the base of the Central Shaft development so as to be able to complete this development without compromising the projected ramp-up from c 57koz Au by end 2018 to 80koz Au by 2020.

## Valuation: Peak capex drives base case up 5%

We have adjusted our model for Q417 and FY17 results. We have also revised our production schedule as per the company's 10 November 2017 announcement (see page 3 for details) and a revised schedule of capital expenditures as per its March 2018 corporate presentation (Exhibit 5). Caledonia's net cash position at end FY17 was US\$11.3m. We note end-year payables grew to US\$12.7m largely due to a c US\$6m payment to ZESA not being paid during Q417. This was not due to a lack of funds on Caledonia's part and will be settled during H118, bringing payables down to a more normal level. We see net cash increasing to US\$14.9m in 2018 (net of dividend payments totalling US\$2.9m), before we see a material shift in FCF generation in 2020 driven by lower IP development capex, when we forecast net cash increasing 45% to US\$21.6m. With capex peaking in FY18, our DCF valuation reflects this strong FCF generation resulting from a successful IP build-out. This drives our DCF up 4.8% from 869p (FY17) to 911p on an FY18 basis. This valuation also reflects a 1.0% weakening in the US\$/£ exchange rate from 1.41 to 1.395.

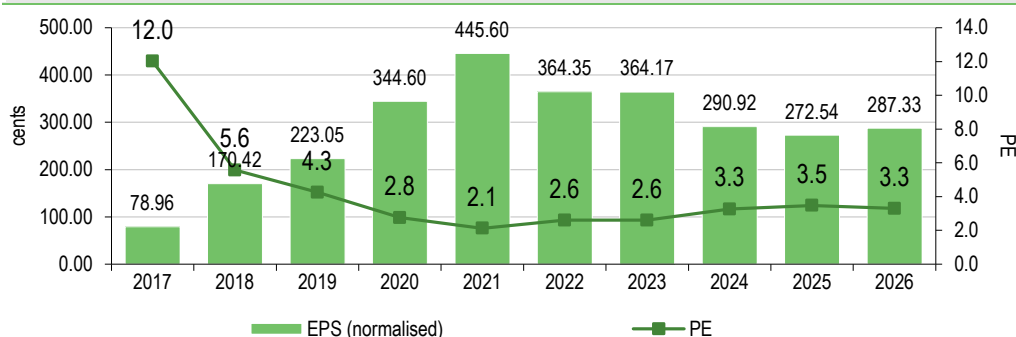
**Exhibit 5: Revised Blanket IP capex schedule 2018-27, US\$m**

	2018e	2019e	2020e	2021e	2022e	2023e	2024e	2025e	2026e	2027e
New capex schedule	(21)	(21)	(14)	(12)	(10)	(10)	(8)	(7)	(6)	(5)
Old Edison capex schedule	(27)	(11)	(6)	(6)	(6)	(6)	(6)	(6)	(7)	(7)

Source: Edison Investment Research and Caledonia Mining March 2018 corporate presentation

## Forward-looking P/E shows CMCL undervalued at current share price

Our earnings projections are given in the following exhibit. The trend of rising earnings extends through to 2021 when Caledonia expects to produce 80koz pa gold at cash costs of US\$501/oz. Our FY17 normalised EPS of 79c grows 115% to 170c in FY18e, and again by 31% to 223c in FY19e. Capital expenditures of US\$21m in FY18 stay level through FY19 before decreasing markedly (by c 33%) to US\$14m in 2020, demonstrating a considerable freeing up of cash resources.

**Exhibit 6: Normalised EPS (LHS) and forward-looking P/E on RHS**


Source: Edison Investment Research

On a P/E basis, the company's successful execution of its IP at Blanket will drive the company's forward-looking P/E multiples lower. Caledonia's FY17 P/E of 12.1x matches the FTSE Mining Index average of 11.3x (as of 19 April 2018) very closely. However, looking forward, earnings generation shows Caledonia undervalued on a P/E multiple of 4.3x FY19e EPS.

## Financials

Caledonia's year-end net cash position decreased by 14.7% from US\$13.0m to US\$11.3m, reflecting the company's increased capital expenditures (including the additional capex required to develop the Central Shaft to 1,330m). We note Caledonia's payables increased to US\$12.6m by end FY17, but also that management states this is largely down to a delay in a c US\$6m payment to the Zimbabwean electricity company, ZESA, which should be made sometime in H118. This was not due to a lack of funds on Caledonia's/Blanket's side. Our projection of Caledonia's working capital position, as well its end-year net cash position, is given in the following exhibit:

**Exhibit 7: Working capital history and forecast 2013-20e**

Year	2013	2014	2015	2016	2017	2018e	2019e	2020e
Payables	4,301	3,260	6,656	8,077	12,660	9,432	7,575	3,295
Creditor days	59	43	81	92	128	100	75	30
Receivables	3,636	1,850	4,236	3,425	4,962	6,137	6,639	8,534
Debtor days	21	13	32	20	26	30	30	30

Source: Caledonia Mining, Edison Investment Research



Our view is that Caledonia's creditor days normalise to a more conventional 30-day turnaround by 2020. We will continue to monitor and adjust the number of creditor days as and when Caledonia's financial results are released.

As long as the company's working capital situation reverts to a more historical pattern, we estimate that it will generate the following net cash flow:

<b>Exhibit 8: Caledonia end year net cash forecast 2014-20e</b>							
<b>Year</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018e</b>	<b>2019e</b>	<b>2020e</b>
Year-end net cash	23.1	10.9	12.9	11.3	14.9	21.6	49.9
Source: Caledonia Mining, Edison Investment Research							

Exhibit 8 above includes all operational, central costs, FY18 dividend payment and capital expenditures, as per our 12 January 2018 note [Record production and 14% increase in grade](#).

Caledonia states that its dividend of US\$2.9m paid quarterly will be maintained in FY18. We have included this for FY18 and await further guidance to forecast this payment beyond the current year.

## Zimbabwean changes to indigenisation

President Mnangagwa assumed leadership of Zanu-PF and became president of Zimbabwe in late 2017. He quickly stated his intention to relax the country's indigenisation policy concerning gold miners. Caledonia's statement on this change is given below. Until formal confirmation of this change and the rights issue are complete (see below), we maintain our model of the indigenisation structure with all indigenous party loan accounts modelled through cash flow.

"These pronouncements have now passed into law and accordingly, the boards of Caledonia and Blanket have agreed to implement a rights issue at Blanket to raise approximately \$4 million which will be underwritten by Caledonia's Zimbabwean subsidiary. Blanket will use the proceeds of the rights issue to advance work on certain of its satellite properties. Assuming that Blanket's indigenous shareholders do not subscribe for shares in accordance with their rights, it is expected that, subject to the terms of the rights issue, Caledonia's shareholding in Blanket will increase from 49 per cent to slightly over 50 per cent.

"Caledonia will also evaluate the potential to buy the shareholdings in Blanket that are currently held by certain indigenous shareholders. However, it is our intention to retain the shareholders representing employees and the local community (both of which currently hold 10 per cent each) as long term shareholders of Blanket. Any transactions would reflect the value of the indigenous shareholders' holdings in Blanket after deducting the value of their outstanding facilitation loans and would be subject to a mutually agreed valuation of the holdings in Blanket."

**Exhibit 9: Financial summary**

	US\$'000s	2016	2017	2018e	2019e	2020e	2021e
Year end 31 December		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
<b>PROFIT &amp; LOSS</b>							
Revenue		61,992	69,762	74,672	80,774	103,836	120,007
Cost of Sales		(38,500)	(43,441)	(44,046)	(48,684)	(53,386)	(54,820)
Gross Profit		23,492	26,321	30,626	32,090	50,450	65,187
EBITDA		23,257	26,192	29,826	40,099	60,482	76,622
Operating Profit (before amort. and except.)		19,766	22,429	24,626	33,599	53,982	70,122
Intangible Amortisation		0	0	0	0	0	0
Exceptionals		(788)	(1,811)	(1,000)	(2,966)	0	0
Operating Profit		18,978	20,618	23,626	30,633	53,982	70,122
Net Interest		(176)	(31)	261	335	468	1,034
Other financial items		0					
Profit Before Tax (norm)		19,590	22,398	24,888	33,934	54,450	71,156
Profit Before Tax (FRS 3)		18,802	20,587	23,888	30,968	54,450	71,156
Tax		(7,717)	(8,691)	(4,444)	(7,250)	(12,225)	(15,984)
Profit After Tax (norm)		11,873	13,707	20,444	26,684	42,225	55,172
Profit After Tax (FRS 3)		11,085	11,896	19,444	23,718	42,225	55,172
Minority interests		(2,797)	(2,512)	(2,468)	(3,157)	(5,409)	(7,137)
Net income (norm)		11,276	8,329	17,975	23,527	36,816	48,035
Net income (FRS3)		8,288	9,384	16,975	20,562	36,816	48,035
Average Number of Shares Outstanding (m)		10.5	10.5	10.5	10.5	10.5	10.5
EPS - normalised (c)		106.9	79.0	170.4	223.1	349.0	455.4
EPS - normalised and fully diluted (c)		92.4	78.2	168.9	221.0	345.9	451.2
EPS - (IFRS) (c)		79.5	86.5	160.9	194.9	349.0	455.4
Dividend per share (c)		28.4	31.4	27.6	0.0	0.0	0.0
Gross Margin (%)		37.9	37.7	41.0	39.7	48.6	54.3
EBITDA Margin (%)		37.5	37.5	39.9	49.6	58.2	63.8
Operating Margin (before GW and except.) (%)		31.9	32.2	33.0	41.6	52.0	58.4
<b>BALANCE SHEET</b>							
Fixed Assets		64,917	82,143	97,943	112,443	119,943	125,443
Intangible Assets		0	0	0	0	0	0
Tangible Assets		64,917	82,143	97,943	112,443	119,943	125,443
Investments		0	0	0	0	0	0
Indigenisation receivable		0	0	0	0	0	0
Current Assets		25,792	27,913	26,418	33,779	64,225	100,980
Stocks		7,222	9,175	2,830	3,030	3,295	3,325
Debtors		3,425	4,962	6,137	6,639	8,534	9,864
Cash		14,335	13,067	16,742	23,401	51,686	87,082
Other		810	709	709	709	709	709
Current Liabilities		(9,832)	(15,602)	(15,733)	(17,320)	(17,974)	(23,474)
Creditors		(8,422)	(13,805)	(13,936)	(15,523)	(16,177)	(21,677)
Short term borrowings		(1,410)	(1,797)	(1,797)	(1,797)	(1,797)	(1,797)
Long Term Liabilities		(19,365)	(23,417)	(23,417)	(23,417)	(23,417)	(23,417)
Long term borrowings		0	0	0	0	0	0
Other long term liabilities		(19,365)	(23,417)	(23,417)	(23,417)	(23,417)	(23,417)
Net Assets		61,512	71,037	85,211	105,485	142,777	179,533
Minority interests		(3,708)	(5,944)	(7,941)	(11,098)	(16,507)	(23,643)
Shareholder equity		57,804	65,093	77,270	94,387	126,271	155,889
<b>CASH FLOW</b>							
Operating Cash Flow		25,631	28,885	31,768	34,574	54,042	62,347
Net Interest		(194)	(161)	261	335	468	1,034
Tax		(2,466)	(4,212)	(4,444)	(7,250)	(12,225)	(15,984)
Capex		(19,885)	(21,639)	(21,000)	(21,000)	(14,000)	(12,000)
Acquisitions/disposals		3	0	0	0	0	0
Term loan facility and equity issuance		3,360	(1,400)	0	0	0	0
Dividends		(2,994)	(3,310)	(2,911)	0	0	0
Net Cash Flow		3,455	(1,837)	3,675	6,659	28,285	35,396
Opening net debt/(cash)		(10,880)	(12,925)	(11,270)	(14,945)	(21,604)	(49,889)
HP finance leases initiated		0	0	0	0	0	0
Other		(1,410)	182	(0)	0	(0)	(0)
Closing net debt/(cash)		(12,925)	(11,270)	(14,945)	(21,604)	(49,889)	(85,285)

Source: Company accounts, Edison Investment Research



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